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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 05262-85
22 October 1985

MEMORANDUM FOR: Director of Central Intelligence

FROM: [REDACTED]

Acting National Intelligence Officer for Economics

SUBJECT: China Luncheon and Discussions, 23 October 1985

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1. Attached for your information are some background papers for your 23 October luncheon meeting on China. The guests were told that we would like to hear their thoughts on doing business in China and their observations on progress in the reform movement. Information on the activities of their firms in China is contained in Tab C.

2. After the luncheon the guests will be briefed by Jim Lilly on his experiences during the Vice President's recent trip and hear from DDI analysts on their views of the reform movement. Following these discussions, the guests will meet again briefly with you before departing.

3. As you can see from the attached materials, the reform movement is going very well from China's perspective. Industrial output and capital spending are growing very rapidly despite efforts by Beijing to cool the pace of expansion. Rapid growth of imports, which has resulted in a sharp drop in foreign exchange reserves, and infrastructure bottlenecks seem to be the key problems.

4. On the nuclear front, the Chinese announced last month that they intend to place some of their nuclear installations under IAEA safeguards. The Chinese want to have 10,000 MW of nuclear capacity on line by the year 2000 and hope to import three plants for completion in the early 1990s.

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Attachments:

- A. Agenda
- B. List of Luncheon Attendees
- C. Information on Guests
- D. "China: Economy Still Overheated"
- E. "China: Recent Economic Reforms"
- F. "China: Submitting to IAEA Safeguards"
- G. "China's Nuclear Power Development"

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22 October 1985

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AGENDA

CHINA DISCUSSIONS

Wednesday, 23 October 1985

12:00 - 1:15 LUNCHEON
Director of Central Intelligence (Host)
DCI Dining Room

1:15 - 2:30 DISCUSSIONS with CIA Analysts
DCI Conference Room, 7D64

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[Redacted]
China Division
Office of East Asian Analysis

2:30 - 3:00 MEETING with the Director of Central Intelligence
Summary of Discussions
DCI Conference Room

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Next 3 Page(s) In Document Denied

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DIRECTORATE OF INTELLIGENCE

China: Recent Economic Reforms

19 April 1985

Summary

China's ambitious economic reform program has gained momentum since April of last year, with reformers--backed by Deng Xiaoping--pushing through major policy directives regarding agriculture and industry. The new policies are not capitalist, but they do represent a pronounced break with traditional Marxist economic practices and, thus, are controversial. Beijing's recent crackdown on economic crimes such as price gouging, speculation, blackmarketeering, and cadre abuse of power, is designed to smooth the way for wage and price reforms that will be implemented later this year.

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Industry

The Third Plenum of the 12th Party Congress in October 1984 placed the party's official stamp of approval on many industrial reform measures that Beijing has experimented with since 1979. The most important industrial reforms approved at the plenum are:

-- Reform of the Planning System. China is gradually moving away from the rigid central planning system modelled on the Soviet Union. Under the reforms, production of items of national importance--such as steel, petroleum products and chemicals--remain under mandatory state quotas. Most products, however, are to be produced under "guidance plans" that are set by the state but that are flexible

This memorandum was prepared by , China Division, Office of East Asian Analysis. It was requested by Department of Commerce. Comments and questions are welcome and should be directed to Chief, Domestic Policy Branch

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enough to enable enterprises to adjust to changing market conditions. Some consumer items and over-quota production of most goods are to be regulated by China's equivalent of an open market.

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-- Enterprise Autonomy. A major goal of the reforms is to increase the authority of enterprise managers and reduce the power of party and government officials in economic decisionmaking. Managers already have more leeway to develop production and marketing strategies, hire and fire workers, and set prices and wages; the control of central ministries and provincial governments is to be reduced correspondingly. Competition between enterprises is encouraged.

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-- Price Reform. In perhaps the most important measure, Beijing has begun to adjust domestic prices and reform the pricing mechanism. Prices of key products such as coal and steel will still be set by the state but at levels that better reflect relative scarcities in the economy. The prices of many other products, including most manufactures, will fluctuate in response to market conditions within bounds set by the state. Supply and demand alone now determine the prices of minor consumer goods such as some clothing products, cosmetics, and vegetables. (U)

-- Wage Reform. Wages, once guaranteed regardless of output or qualifications, will now reflect job performance. Workers with greater productivity will receive higher wages. Wages will also reflect seniority, the cost of living, and skills in great demand.

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-- Tax System. Instead of turning all profits over to the government, enterprises pay a share of their profits in taxes. Enterprise managers can use after-tax profits for worker bonuses or investment.

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-- Bank Reform. The banking system is being reorganized. Bank loans are increasingly replacing government grants as the source of capital for enterprises. Banks now have increased authority to approve or deny loans, and some banks may adjust loan rates within a 20-percent range of the state-set rates.

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-- International Trade. International trade and foreign investment in China is being strongly encouraged. City and provincial governments have more authority to deal with foreign firms. Foreign trade enterprises can now operate as commissioned agents for manufacturers and importers of most products. Some of China's key state

2
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enterprises are allowed to engage directly in discussions with foreign businessmen and have independent authority to sign contracts for technological transformation projects, joint ventures, and compensation trade operations. Foreign firms engaged in joint venture production can sell their output within China as long as the venture's foreign exchange expenditures and receipts are balanced.

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The industrial reforms approved in 1984 are designed to correct continuing problems in the urban economic sector:

- Inefficiency, waste, and quality problems that persist despite double-digit growth in both 1983 and 1984.
- Commercial and transportation systems that are incapable of handling agricultural surpluses and record production of coal and other raw materials.
- Party and State bureaucracies that continue to meddle extensively in day-to-day business activity, stifling enterprise initiative and productivity.
- Increased subsidies to urban households that have contributed to six consecutive budget deficits totalling \$28 billion.

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Agriculture

In its first major policy statement of 1985, Beijing signalled its intention to place greater reliance on market forces to guide agricultural production. Instead of purchasing all grain produced--and paying a premium price for over-quota production--the state will sign production contracts with individual farmers for a specified quantity of grain. Both the contracted amount of grain and the purchase price will be less than previous averages. Peasants will be encouraged to sell surplus production on the open market, but the state will purchase excess grain if the free market price falls below a state-determined minimum price. Peasants growing grain on land ill-suited to grain production will be offered subsidies to raise livestock or grow cash crops. In addition, price controls on pork and vegetables are being lifted.

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The new policies are designed to promote the development of a diversified agricultural sector and to encourage peasants to produce better quality products and make more efficient use of their land. Beijing also wants to reduce the growing surplus of grain caused by earlier agricultural reforms and to relieve the financial burden imposed by the previous commitment to purchase all over-quota production at premium prices.

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Is this Capitalism?

Although a distinct departure from orthodox central planning, the recent reforms will not transform China into a capitalist economy. The state will continue to own the means of production, will still have direct control over output, pricing, and distribution of key products, and will continue to make major investment decisions. The state will also retain the right to appoint or remove enterprise managers and shut down inefficient enterprises.

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Problems Accompanying Reform

Although reforms have contributed to rapid economic growth, large increases in personal income and in the money supply and strong industrial demand for raw materials have caused a surge in prices during the past six months. Recently, the Chinese media has suggested a high-level concern with several major problems including inflation, a 1984 budget deficit that was almost twice as large as expected, and a sharp increase in economic crimes such as price gouging, smuggling, and fraud. Beijing anticipated dislocations in the early stages of urban economic reform, but probably has been surprised at the extent to which local officials and enterprise managers have taken advantage of loose reform guidelines to make windfall profits.

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The emergence of these problems appears to have intensified debate within the leadership about the direction and pace of economic reforms, and conservative leaders have become more vocal in expressing practical and ideological concerns about the new policies. Reform leaders have responded by tightening supervision of bank credit and worker bonuses and by promising to punish those guilty of economic crimes. The reformers seem determined to press ahead, but we expect them to proceed cautiously, particularly when implementing price reform.

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DIRECTORATE OF INTELLIGENCE**30 July 1985****China's Nuclear Power Development: Do US Firms Still Have a Chance?****Summary**

The Sino-US nuclear agreement signed last week allows US firms a belated entry into the long-running competition to sell nuclear power plant technology and equipment to China. Although Beijing supposedly wants to conclude contracts this year, the US is by no means out of the running. The fact that an extremely attractive deal from West Germany has not yet been signed probably indicates that the Chinese waited for a chance to negotiate with US firms. Beijing may only use US proposals to increase leverage on other bidders, but there are strong indications that some fairly influential Chinese are still disposed to seek US technology for the commercial nuclear program. Even if this preference exists, the nuclear agreement does not guarantee US firms any sales: the Chinese can be expected to continue to hammer away at all vendors' offers to secure the best possible deal.

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Vice-Premier Li Peng, who visited the US for the first time, is a major influence on the direction of China's nuclear program. Li is apparently agreeable to hearing US proposals, but may not be convinced that the US presents a financially attractive source of technology. His visit

This memorandum was prepared by [redacted] Office of East Asian Analysis. 25X1
 Information available as of 30 July 1985 was used in its preparation. Comments and
 queries are welcome and may be directed to the Chief, Development Issues, China
 Division, OEA [redacted]

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provided US industry with a key opportunity to promote its strengths in transferring nuclear power plant technology. [redacted]

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A Crucial Year

This has been a year of increasing activity for the Chinese commercial nuclear program. The Seventh Five-Year Plan is being formulated, and efforts to develop nuclear power will have to show results for projects to receive state funding. The Chinese want to have 10,000 MW of nuclear capacity on-line by the year 2000, supplying about 5 percent of China's electric power; they hope to have three imported plants (at Guangdong, Sunan, and Liaoning) and a "domestic" effort (Qinshan, or the 728 plant) complete in the early 1990s (see Figure 1). [redacted]

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Political Progress...

In their efforts to obtain nuclear plants and equipment, the Chinese have signed a number of nuclear cooperation agreements, particularly in the last four months (Figure 2). These agreements have served other purposes as well. The Chinese have increased their access to suppliers of ancillary equipment; they have widened their research and development contacts worldwide; and in successive negotiations they have shown increasing willingness to place internationally-accepted restrictions on their nuclear dealings. Taken together with their growing involvement in the International Atomic Energy Agency, the Chinese hoped these agreements would assuage the proliferation concerns of the US and Japan, who had been the two major holdouts in nuclear cooperation agreements with Beijing. [redacted]

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Commercial Delays

Commercial negotiations for individual projects continue to lag in spite of the progress on the political front. Deadlines for Guangdong and Sunan have come and gone, and no final contracts have been signed. [redacted]

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The Chinese have hammered away at French prices on Guangdong for years, but still are not satisfied. The French said recently that the Chinese wanted prices for Guangdong reduced another 20 percent, a ludicrous amount at this stage of the game. Separate talks on plant financing and equipment prices both apparently ended in deadlock a few days after the Sino-US signing. [redacted]

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Although the West Germans are proposing an extremely attractive deal for China's Sunan plant northwest of Shanghai that includes tech transfer, compensatory trade financing and Chinese provision of waste disposal as partial payment, the Chinese so far have merely signed a non-compulsory memorandum of understanding to buy West German reactors, similar to the agreements signed with France in 1978 and 1983. [redacted]

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Japan has already sold a reactor pressure vessel to China for a small, domestically-built plant (Qinshan), but even with an agreement signed in July and strong industry lobbying efforts in Beijing, it did not expect to bid on China's intended complete plant imports. [redacted]

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Interest in US Participation

Several incidents this year suggest that at least part of the Chinese bureaucracy is still anxious to include the United States as a possible participant in the commercial nuclear power program. In January, Vice-Premier Li Peng repeated Zhao Ziyang's non-proliferation statements to the press before the Guangdong joint venture signing. The Chinese were noticeably upset when these statements received scant attention in the American press; Li's statements were intended as an obvious signal to the US regarding the stalled nuclear agreement. [redacted]

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Jiang Shengjie, former Vice-Minister of the Minister of Nuclear Industry (MNI) who is now head of both China's Nuclear Safety Bureau and the China Nuclear Society, as well as chairman of MNI's Science and Technology Commission, has repeatedly sought to include US firms in nuclear seminars in China. He also has pressed US industry over the last year to develop its ties with China's Nuclear Power Plant Negotiating Team (NPPNT). The NPPNT has been given the responsibility of negotiating with foreign vendors and making recommendations on suppliers to the State Council; its head, Lin Zhongtang, has refused to meet with US vendors in the absence of a bilateral. [redacted]

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Competitive Advantages of US Firms

The US enjoys several competitive advantages as a nuclear supplier to China. Westinghouse's track record in transferring nuclear power technology to other countries is unmatched. Kraftwerk Union's (KWU's) success in transferring technology to Brazil and Argentina is noteworthy, but the technology KWU is offering China may be less sophisticated than that offered by Westinghouse. [redacted]

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China's desire to become a nuclear plant exporter for the Pacific Basin make Westinghouse technology and training even more attractive. Beijing is unsure of its ability to earn foreign exchange into the next century from its oil and textiles, and hopes to develop its export capabilities over a wide range of capital construction activities, including nuclear, as a source of foreign exchange earnings. Recipients of KWU technology in Argentina and Brazil are not actively selling nuclear plants and components in the international market, as are current and former Westinghouse licensees in France and Japan. [redacted]

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Several other factors favor US participation in the nuclear program in China. The US is already heavily involved in China's nuclear safety efforts as a result of the nuclear safety protocol, which led to the creation of a Nuclear Safety Bureau modeled after the US Nuclear Regulatory Commission. US nuclear engineering firms have proved their

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expertise to China and several have already been contacted to evaluate bid proposals from other parties. Other US firms are submitting bids on non-nuclear components of Chinese nuclear plants. [redacted]

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Disadvantages facing US firms

The main disadvantage faced by US firms will be their late entrance into full-fledged commercial negotiations. The Chinese have been bargaining with the French since 1983 and with West Germany since the middle of last year. The burden will be on US firms to show that a US bid to supply plants for Sunan or Guangdong can match proposed French or German deliveries. [redacted]

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Another disadvantage is the cost of US technology. The West Germans are supposedly offering technology transfer at lower cost than the US would, and are willing to negotiate compensatory trade as well. [redacted]

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Prospects for US Sales

Prospects for US sales to China depend on whether Beijing is seriously interested in negotiating with the US at this late date; whether price alone will determine the choice of vendor; and whether the Chinese decide to focus on a single technology. [redacted]

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China appears seriously interested in negotiating with US nuclear firms, and talks with other vendors are apparently deadlocked. However, Beijing's desire to conclude the nuclear agreement stemmed from political as well as economic motives. It is possible that China has already ruled out US sales, but is stalling in negotiations with France and Germany so as not to deflate the US initiative in carrying the bilateral through to completion. [redacted]

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Even if US firms do have time to negotiate for business in China's nuclear power program and are the preferred source of supply, they may not realize the \$US6-10 billion in sales to the PRC that they originally expected. Beijing appears willing to bargain almost indefinitely for low prices and cheap financing. China may fill its nuclear equipment needs through the 1980s by relying on a pool of suppliers, keeping bidding competitive on future nuclear plant and component purchases. In this bidding environment, US firms would do well to sell a single complete plant or a handful of components. [redacted]

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If the Chinese decide to make a concerted effort to assimilate nuclear technology to build plants for both domestic use and for export, the choices boil down to low-cost German technology that maybe transferred less effectively versus higher-cost US technology with a proven record of successful tech transfer. In this bidding environment, Chinese assessments of the strengths of the two countries' offerings may carry more weight than considerations of price. [redacted]

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The role of Li Peng

In this context, Li Peng's role in the nuclear program makes his visit to the United States critical to US sales prospects. Li was personally responsible for negotiating the memoranda of understanding with France and Great Britain in 1983 for the Guangdong Nuclear Power Plant. Shortly thereafter he was promoted from Vice-Minister of Water Resources and Electric Power (MWREP) to Vice-Premier of China. As Vice-Premier he has been consolidating his control over the energy portfolio, including coal and electric power.

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The head of the NPPNT, Lin Zhongtang, has avoided dealing with US firms in the absence of a bilateral agreement; he reportedly is convinced that the West German Kraftwerk Union (Kwu) reactor is the best deal China can hope for. Li Peng's impressions of the US nuclear industry resulting from his visit may lead to NPPNT contacts with US industry and could prove a deciding factor in China's choice of nuclear power equipment and technology.

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